SPHERE Teaching Civic Culture Together

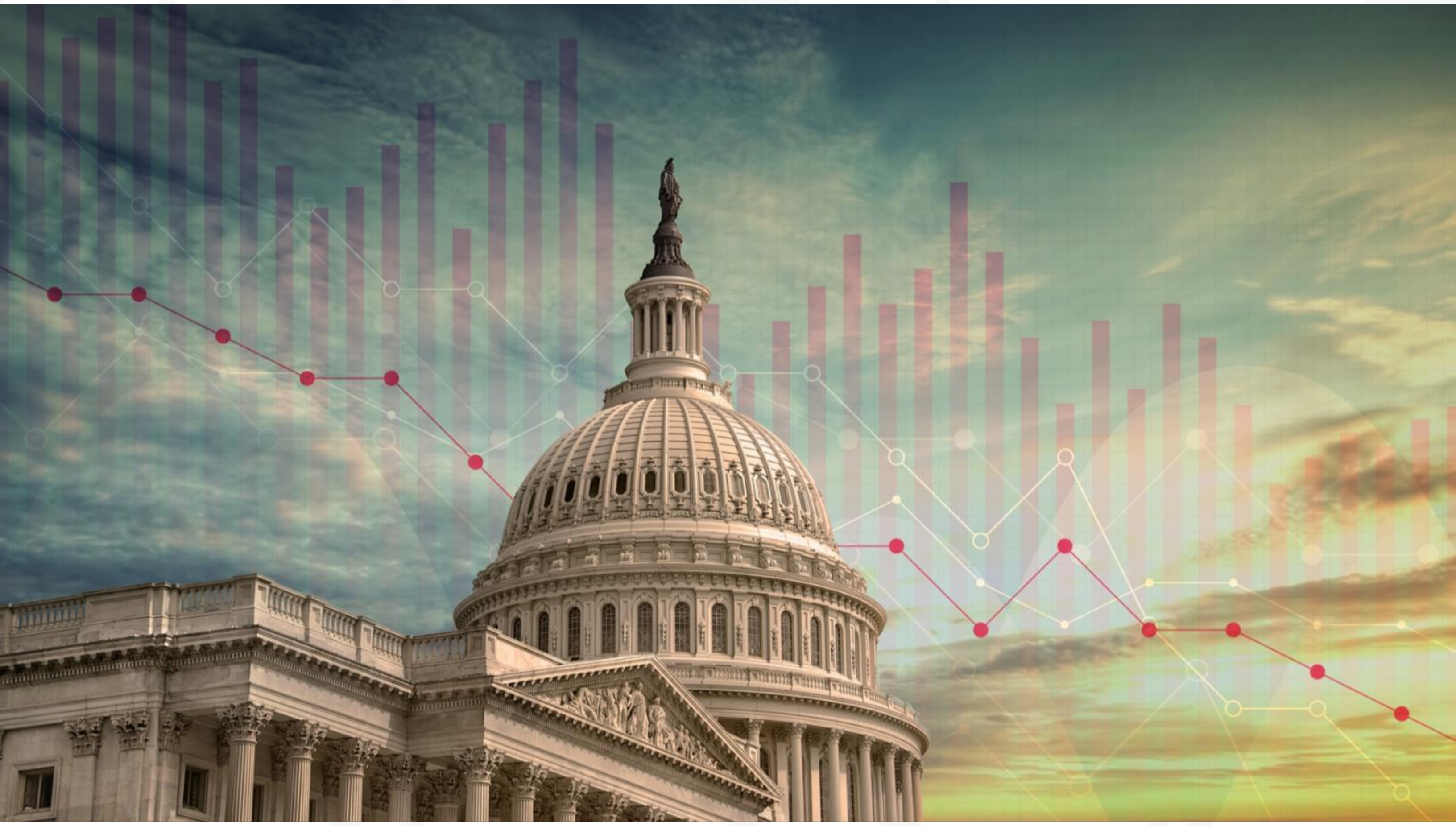
REAL WORLD ECONOMICS

Market Failure versus Government Failure

GRADE LEVEL: 9TH–12TH GRADES
TIME ESTIMATE: 50-MINUTE CLASS PERIOD

Lesson Overview and Introduction

Market failure occurs when the free-market system fails to allocate resources efficiently, resulting in a loss of economic and social welfare. Externalities, or the spillover effects of economic activity on third parties, arise with a market failure. For example, a factory may emit pollution that harms the health of nearby residents, but the cost of that pollution is not reflected in the price of the goods produced by the factory. This results in an inefficient allocation of resources since the costs are not borne by the producer but by those not involved in a market transaction.



Government failure, on the other hand, occurs when government intervention in the market reduces economic and social welfare. One example of how government failure can manifest is with the law of unintended consequences, the idea that actions taken with good intentions can have unanticipated and negative consequences. Another example of government failure is rent seeking, where individuals or firms use political influence to obtain economic benefits at the expense of others. Rent seeking results in an inefficient allocation of resources, since resources are allocated on the basis of political power rather than economic efficiency. For example, a company may lobby the government to reduce competition in a particular industry, which would allow it to charge higher prices and earn greater profits at the expense of consumers.

This lesson will examine how both market failure and government failure can result in an inefficient allocation of resources and a loss of economic and social welfare. Students will also learn why It is important for policymakers to consider both of these types of potential failure when designing policies to address economic problems, and to be aware of the potential unintended consequences of their actions.

Objectives

- Students will understand how policies with good intentions can lead to unintended consequences, producing a less-than-optimal outcome.
- Students will understand how market failure and government failure result in an inefficient allocation of resources and a loss of economic and social welfare.
- Students will be able to describe several examples of real-world market failures and government failures and their significance.

Vocabulary

- Incentives
- Law of unintended consequences
- Government failure
- Market failure
- Negative externalities
- Public goods
- Positive externalities

Materials

Printed copy of this article from Econlib: "Rent-Seek and You Will Find"

Warm-Up (10 minutes)

Begin by asking the class a few questions and playing a short video.

- Ask students a few questions regarding incentives, such as:
  - What would happen to class grades if I gave $500 to every person who got an A on the next exam?
  - What if your boss offered you double pay to work on the weekends?
- Tell the class that these are examples of economic incentives, and define the term: **Incentives:** Changes in costs and benefits that influence the behavior of individuals or organizations
- Ask students if they can think of any examples of when incentives have changed their behavior or a decision they made. How did the incentive influence their decision?
- Tell the class that actions often have unintended consequences, as people respond to incentives in ways that are sometimes surprising. Define the law of unintended consequences: **Law of unintended consequences:** The idea that actions or policies put in place to achieve a certain goal can often have unexpected and unintended outcomes
- Tell the class that in India, when the country was ruled by the British, the rulers tried to get rid of the nuisance of cobra snakes by paying a bounty for their capture. Ask students to predict any unintended consequences that resulted from the policy.
- Show the video *What Cobras Can Teach Us about Incentives* (2:40) and discuss the following questions:
  - How did cobra breeders respond to the policy?
  - Why didn't the new policy solve the problem?
  - Can you think of any examples of incentives that have been implemented in your community or on the national level? Did they have the intended effect?
- Conclude the introduction by telling the class that the attempt to rid India of cobras is a clear example of government failure, and define the term for the class: **Government failure:** When government intervention in the market reduces economic and social welfare

Activity Part One (20 minutes): Market Failure

Tell the class that just as government policies can fail, so can the operation of free markets. Define market failure for the class:
Market failure: When the free-market system fails to allocate resources efficiently, resulting in a loss of economic and social welfare.

Next, define negative externalities:
Negative externalities: Costs imposed on third parties who are not involved in the production or consumption of a good or service.

Ask students for examples in which the free market produces negative externalities. Examples may include pollution, climate change, or secondhand smoke.

Show this video from Crash Course Economics on market failures (12:11). (Optional: you may define the following terms for the class before showing the video).
Public goods: Goods or services that are nonexcludable and nonrivalrous, meaning they cannot be excluded from anyone and their consumption does not reduce the amount available to others (example: national defense).
Positive externalities: Benefits that are enjoyed by third parties who are not involved in the production or consumption of a good or service (example: education).

After the video, have students answer the following questions individually, in small groups, or as a class.

- What is a market failure? Give examples of market failures you have observed in your community or region.
- Provide and describe examples of positive and negative externalities from the video.
- Describe an example of the tragedy of the commons from the video.
- What is the role of government in correcting market failures? Is it always appropriate for the government to intervene in the market?
- How do market failures affect society as a whole? Have market failures affected your life?

Activity Part Two (15 minutes): Case Study of Government Failure

Tell the class that they will now learn about a specific type of government failure, rent seeking. Define the term:
Rent seeking: Where individuals or firms use political influence to obtain economic benefits at the expense of others

Read the following article from Econlib: "Rent-Seek and You Will Find." Have students answer the following questions individually, in small groups, or as a class. Note: Teachers may have students read only the first section or may assign the whole article for classes with more advanced students.

- How does rent seeking behavior contribute to government inefficiency?
- What are some of the costs associated with rent seeking behavior that are described in the article?
- Describe how the grant process for housing in Charlotte is an example of government failure.
- The author states that the U.S. political system is dominated by two firms. What does he mean by this, and what are the ramifications, according to the author?

Activity Part Three (5 Minutes): Exit Ticket

Give students the following prompt to write a two- or three-sentence exit ticket:
What do you think is the more significant problem for our society today, government failure or market failure? Give specific examples from today's lesson.

Extension

Option 1: Have students read this article on market and government failure from the Library of Economics and Liberty: "Public Goods and Externalities." Then have them answer the following questions:

- What is the free-rider problem, and how does it relate to public goods? Give an example.
- How do markets solve the problem of free-riders in the provision of public goods? Give some examples.
- Explain what externalities are, and give examples of both positive and negative externalities.
- What is the argument against the private provision of lighthouses? How do you think the lighthouses in 19th-century England were privately owned, and how did their owners solve the problem of free-riders?
- How can well-defined property rights solve public goods problems in environmental areas, such as land use and species preservation? Give an example of how private property rights have helped endangered species like the elephant thrive in Africa.

Option 2: Show students this video (5:37) on unintended consequences. The video describes several different government policies and then follows with the negative unintended consequences. Pause the video before each consequence is revealed, and see if the class can predict the outcome.